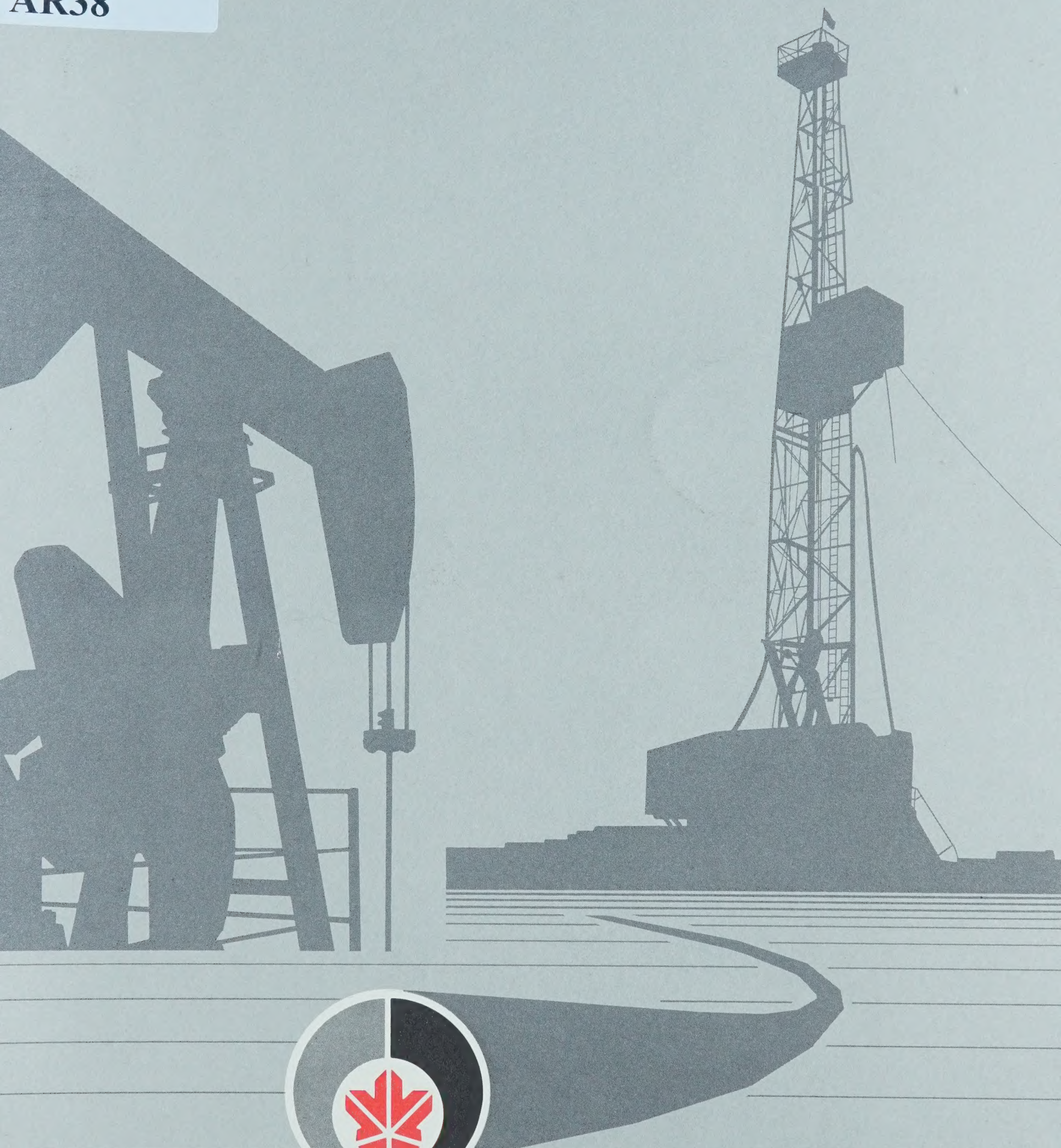


Canadian Reserve Oil and Gas Ltd.

ANNUAL REPORT 1978

CORPORATE INFORMATION

DIRECTORS

R. Bruce Bailey, Calgary
President, Canadian Reserve Oil and Gas Ltd.

Cortlandt S. Dietler, Denver
President, Western Crude Oil, Inc.

Harry Hole, Edmonton
Vice-President, Lockerbie and Hole Western Limited

Maclean E. Jones, Q.C., Calgary
Partner, Jones, Black & Company

Paul D. Meadows, Denver
President and Chief Executive Officer, Reserve Oil and Gas Company

John R. McMillan, Los Angeles
Chairman of the Board, Reserve Oil and Gas Company

DIRECTOR EMERITUS

Howard C. Pyle, Los Angeles
Petroleum Investments

CONTENTS

ANNUAL MEETING

The Annual General Meeting of Shareholders of the Company will be held at the Calgary Inn, Calgary, Alberta, on April 17th, 1979 at 10:00 a.m. (Calgary Time).

OFFICERS

John R. McMillan
Chairman of the Board

Paul D. Meadows
Vice-Chairman of the Board and Chief Executive Officer

R. Bruce Bailey
President

Joe R. Dundas
Senior Vice-President

David W. Talbot
Vice-President and Secretary-Treasurer

Ronald W. Ambrose
Vice-President - Exploration

J. Edouard Michaud
Vice-President

Grant D. Richards
Assistant Secretary-Treasurer and Controller

Tom L. Deen
Assistant Secretary

HEAD OFFICE

639 - 5th Avenue S.W.,
Calgary, Alberta, T2P 0M9
Telephone: 266-6081

AUDITORS

Arthur Young, Clarkson, Gordon & Co.
850 Elveden House,
717 - 7th Avenue S.W.,
Calgary, Alberta, T2P 0Z3

REGISTRAR

Guaranty Trust Company of Canada
311 - 8th Avenue S.W.,
Calgary, Alberta, T2P 1C7

TRANSFER AGENT

Guaranty Trust Company of Canada
Calgary, Alberta; Vancouver, British Columbia; Toronto, Ontario; Montreal, Quebec

STOCK EXCHANGE LISTING

Toronto Stock Exchange

HIGHLIGHTS 1978

(Dollar amounts in thousands except per share figures)

Signing of a 60 million dollar joint exploration agreement by R. B. Bailey of Canadian Reserve and W. G. Stewart of Union Gas Limited.

	1978	1977	% Change
Gross Revenue	**$23,769**	$21,298	+12
Cash Flow	**$13,713**	$12,244	+12
Per Share	**$ 1.42**	$ 1.27	
Net Earnings	**$ 6,885**	$ 6,705	+ 3
Per Share	**$ .71**	$ .70	
Working Capital at Year End	**$ 7,540**	$ 4,494	+68
Property & Equipment Additions	**$16,939**	$11,199	+51
Oil and Natural Gas Liquids Sales (Before Royalty Deduction)			
Barrels	**2,104,009**	2,125,108	− 1
Barrels Per Day	**5,764**	5,822	
Natural Gas Sales (Before Royalty Deduction)			
Mcfs	**6,654,644**	8,069,382	−18
Mcfs Per Day	**18,231**	22,107	
Wells Drilled — Net			
Oil	**48**	15	
Gas	**15**	9	
Dry	**13**	12	
Total	**76**	36	+111
Acreage — Net Working Interest	**1,341,723**	1,621,183	−17
Outstanding Shares	**9,664,837**	9,648,437	+0.2

TO THE SHAREHOLDERS

1978 was a successful year for Canadian Reserve Oil and Gas Ltd. Gains were achieved in all important financial areas. Gross revenues increased by 12% to $23,769,000 or $2.46 per share and cash flow increased by 12% to $13,713,000 or $1.42 per share. Cash flow before income tax was $14,767,000 or 6% greater than in 1977. Net earnings increased 3% to $6,885,000 or $.71 per share as compared with $.70 per share for the previous year.

The increases in all financial categories were lower than anticipated. This was due mainly to marketing problems in Alberta, marketing and production problems in northeastern British Columbia, and the minimal return to the producer from increased natural gas prices.

Gross sales of oil and natural gas liquids were 5,764 barrels per day. Gross natural gas sales were 18.2 mmcf/d, and gross sulphur sales for the year totalled 25,607 long tons.

Canadian Reserve holds interests in 453,000 acres in the heavy oil areas of Alberta and Saskatchewan. As a result, the Company was in a preferred position respecting exploration when major purchasers of natural gas did not contract for additional volumes in 1978 and restricted existing contracts to minimum levels or less. The Company was able to change emphasis from exploration in the natural gas prone areas of Alberta to a renewed and active exploration program in the heavy oil areas. There is an ongoing market for heavy oil which permits the Company to place new discoveries and development wells on production in a relatively short period of time. Consequently, cash flow is created by production from primary recovery operations while enhanced recovery pilot projects are being developed and natural gas markets improve. Canadian Reserve expended $6,500,000 on capital expenditures in the heavy oil areas in 1978 and has budgeted for capital expenditures of over $9,000,000 in 1979.

R. B. Bailey
President

A new heavy oil field was discovered by the Company at Macklin in the Province of Saskatchewan. In 1978 the Company drilled 30 wells on acreage in which its interest ranges from 50% to 100%. When the pool is completely developed, it is estimated that production will be in the order of 800 to 1,000 barrels of oil per day.

During 1978, the Company participated in initiating a fireflood and steam stimulation pilot project at Eyehill in Saskatchewan and instituted a caustic pilot project at North Epping in Saskatchewan. While results from these pilot projects take time to obtain and evaluate, the Company predicts such projects will substantially increase the quantity of heavy oil recoverable from similar pools when applied on a large scale.

At Dahl in northeastern British Columbia the Company, as Operator, drilled 14 wells of which 10 resulted in natural gas producers. In June of 1978, these wells were tied in to marketing facilities resulting in 8 mmcf/d initially being marketed, of which 2 mmcf/d was net to the Company. The Company has working interests which range from 25% to 50% in 34,000 acres in this area. The field was shut-in for a short period during the summer months, but was placed back on stream in November of 1978.

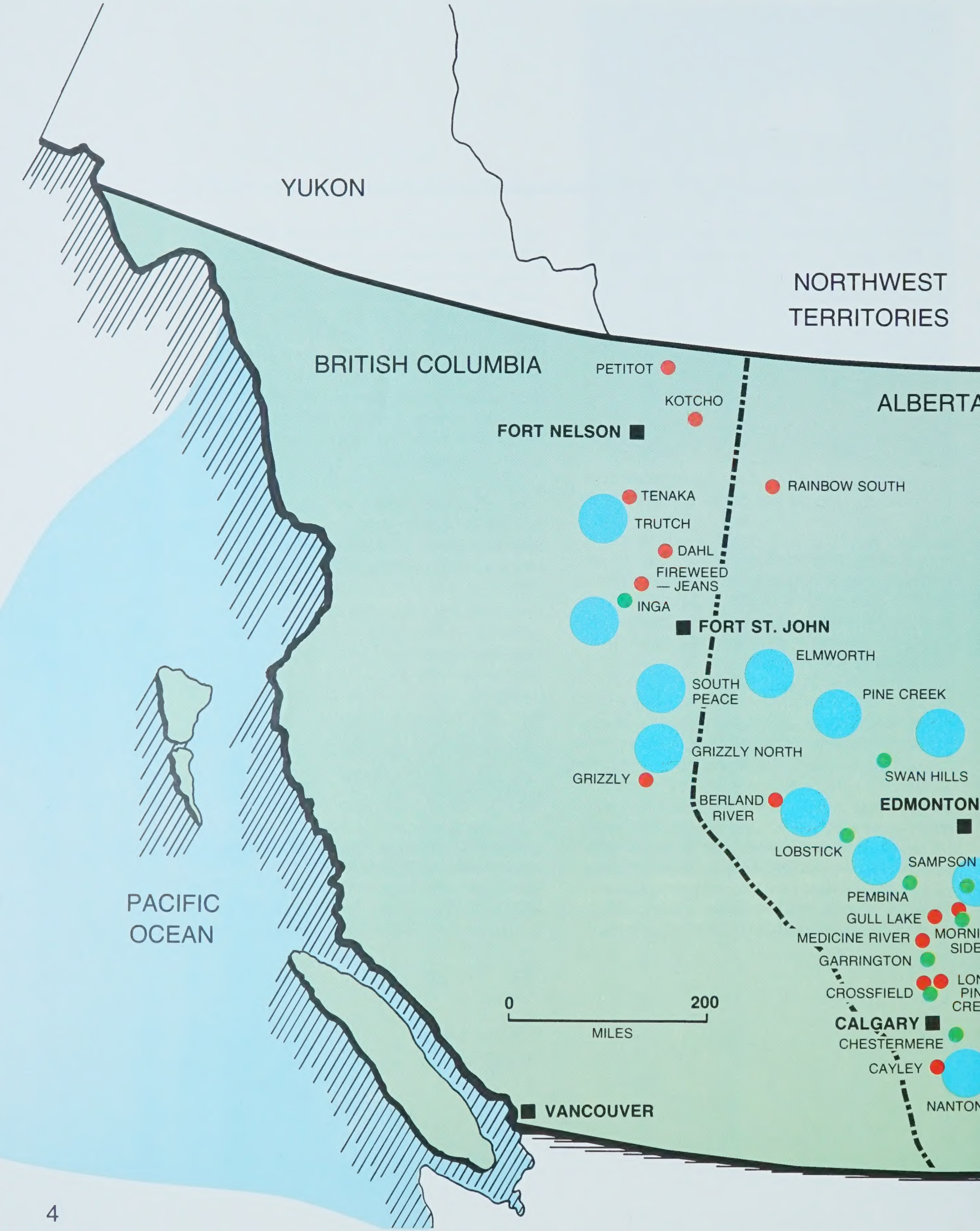
In June of 1978, Canadian Reserve consummated a major Joint Venture Agreement with Union Gas Limited. The Agreement, effective January 1, 1978, is for a period of 3 years and involves an expenditure of $60 million for exploration of which $36 million has been committed by Union. A further commitment to spend additional dollars for development as required is also part of the Agreement. The Company believes the joint venture is a significant advance in its long range planning and will permit expansion of exploration activity in western Canada. The program involves all areas of the Western Canadian Basin, including geological prospects in the Deep Shelf and Foothills regions of western Alberta and British Columbia. Under this Agreement, Canadian Reserve drilled 5 prospects in the Foothills and Deep Shelf areas of Alberta and British Columbia, 4 of which resulted in natural gas discoveries. A significant portion of the funds will also be used to increase the Company's drilling and development activities in the heavy oil areas of Alberta and Saskatchewan.

The Company made two changes to senior management during 1978. Joe R. Dundas was appointed Senior Vice-President and Ronald W. Ambrose was appointed Vice-President, Exploration.

The past year was a rewarding one for Canadian Reserve and we look forward to continued progress in the future. We expect 1979 to be a good year with new highs again being achieved in revenues and net income. The Company has planned an active exploration and development program in 1979 during which it plans to participate in the drilling of more than 250 exploration and development wells in western Canada.

With a continued high level of dedication and accomplishment of our 105 employees, we should accomplish our objectives in 1979. On behalf of the Board of Directors, I thank the employees for their efforts.

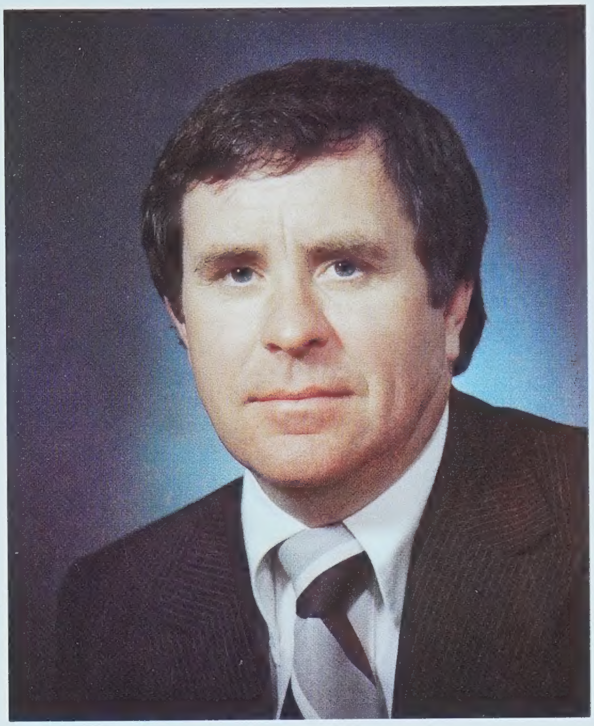
R. Bruce Bailey
President


YUKON
NORTHWEST
TERRITORIES
BRITISH COLUMBIA
ALBERTA
PACIFIC
OCEAN
PETITOT
KOTCHO
FORT NELSON
RAINBOW SOUTH
TENAKA
TRUTCH
DAHL
FIREWEED
— JEANS
INGA
FORT ST. JOHN
ELMWORTH
SOUTH
PEACE
PINE CREEK
GRIZZLY NORTH
SWAN HILLS
GRIZZLY
BERLAND
RIVER
EDMONTON
LOBSTICK
SAMPSON
PEMBINA
GULL LAKE
MEDICINE RIVER
GARRINGTON
CROSSFIELD
CALGARY
CHESTERMERE
CAYLEY
NANTON
VANCOUVER
0
200
MILES

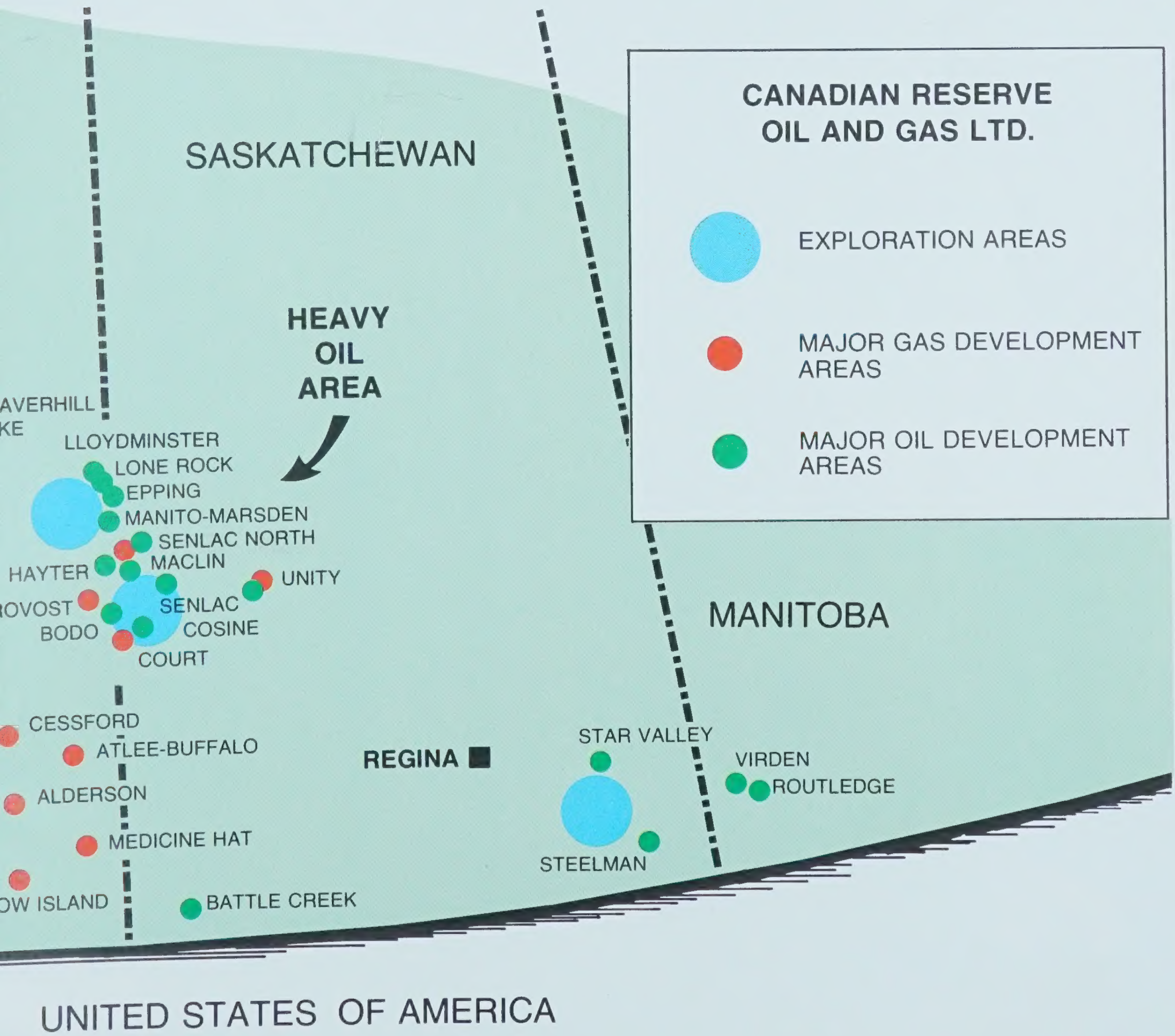
COMPANY PROFILE

Canadian Reserve Oil and Gas Ltd., successor to Fargo Oils Ltd., is an Alberta incorporated company engaged in exploration, development and production of oil and natural gas, primarily in western Canada. The Company has interests in petroleum and natural gas lands, pipelines, gas processing facilities and mining properties.

The corporate office is located in Calgary, Alberta and is currently staffed with 72 employees. In addition, the Company maintains a district office at Lloydminster, Alberta staffed with 33 employees.



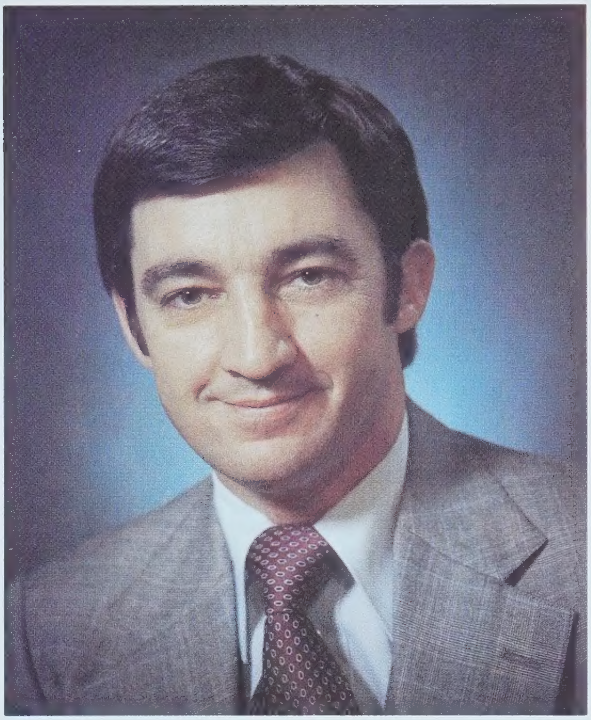
J. R. Dundas
Senior Vice-President



Drilling Rig in the Dahl Area of N.E. British Columbia, where the Company conducted a 14 well development program in 1978.

EXPLORATION AND DEVELOPMENT

In 1978, Canadian Reserve again carried out the most active exploration and development program in the Company's history. The Joint Venture Exploration Agreement which Canadian Reserve signed with Union Gas Limited in June provided the additional funds required to pursue promising exploratory opportunities in western Canada. Of the total number of exploratory wells in which Canadian Reserve participated, 8 were drilled in northeastern British Columbia, 21 were drilled in Alberta, 39 were drilled in the heavy oil areas of Alberta and Saskatchewan and 2 were drilled in southeastern Saskatchewan. Following is a summary of the areas in which the company concentrated its exploration and development efforts in 1978.



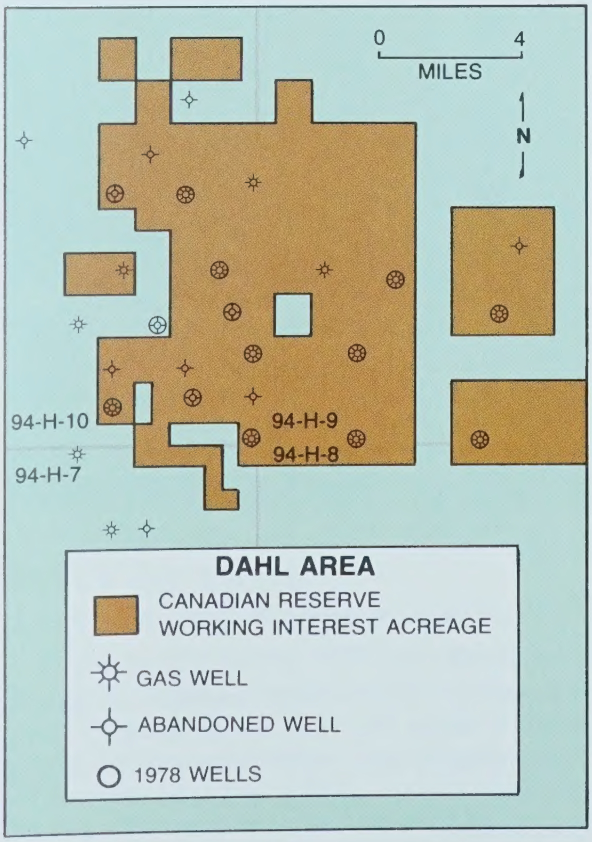
R. W. Ambrose
Vice-President — Exploration

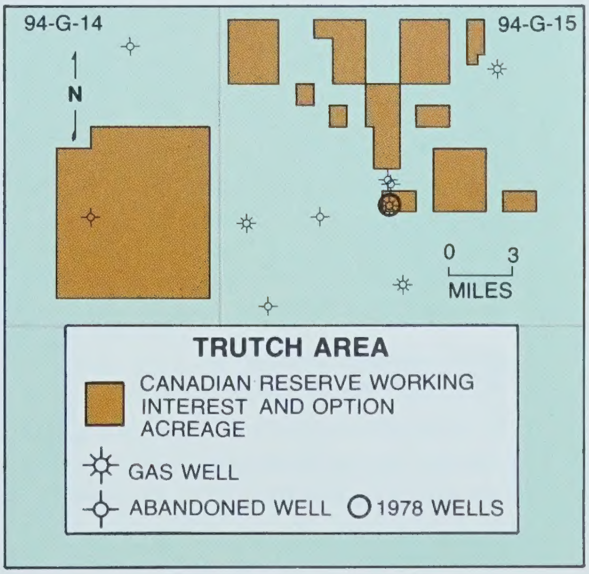
BRITISH COLUMBIA

Canadian Reserve's aggressive drilling effort in northeastern British Columbia during 1978 has resulted in the discovery of new oil and natural gas reserves. The Company participated in 24 wells (4.7 net) resulting in 2 oil wells (0.3 net) and 16 natural gas wells (4.4 net).

Dahl

Canadian Reserve as Operator drilled 14 wells in this area, of which 10 resulted in Bluesky natural gas wells. Canadian Reserve has working interests in 34,000 acres in this area.



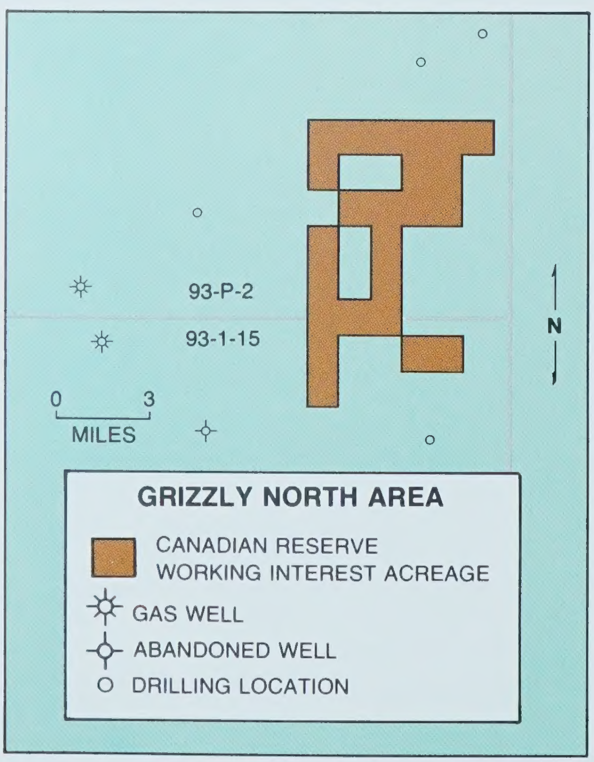


Trutch

The Company has interests or has made arrangements to earn interests in 70,000 acres in the natural gas prone Trutch area. The area has significant natural gas shows in the Halfway, Debolt and Slave Point formations. Canadian Reserve has drilled one Cambrian test with encouraging results and plans further seismic, drilling and land acquisitions in 1979.

Grizzly North Area

Canadian Reserve, with partners, purchased a 17,588 acre drilling reservation in this highly gas prone area of British Columbia. The Company holds a 25% interest in this reservation and plans to conduct seismic operations and drilling in 1979.



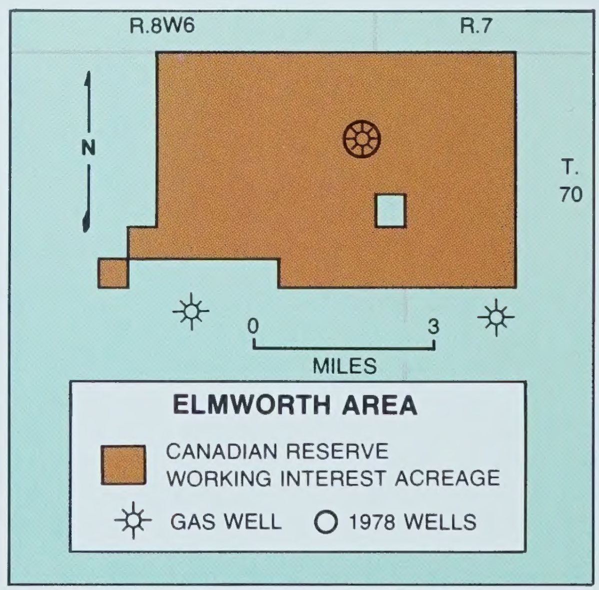
General

Canadian Reserve has acquired additional acreage through Crown sales and farmins in the Sunrise and Prophet River areas of northeastern British Columbia. Seismic programs and drilling are planned for these areas in 1979.

NORTHERN ALBERTA

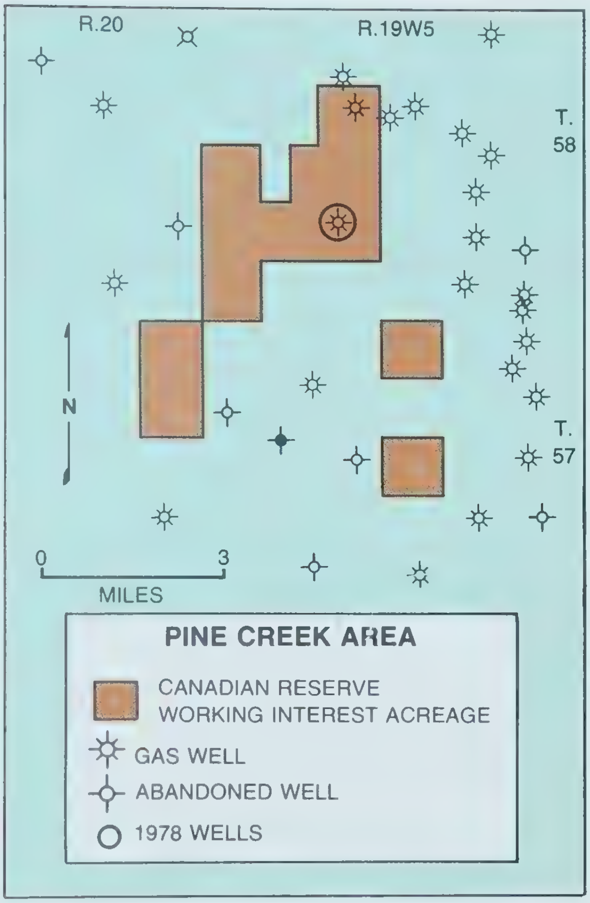
Elmworth

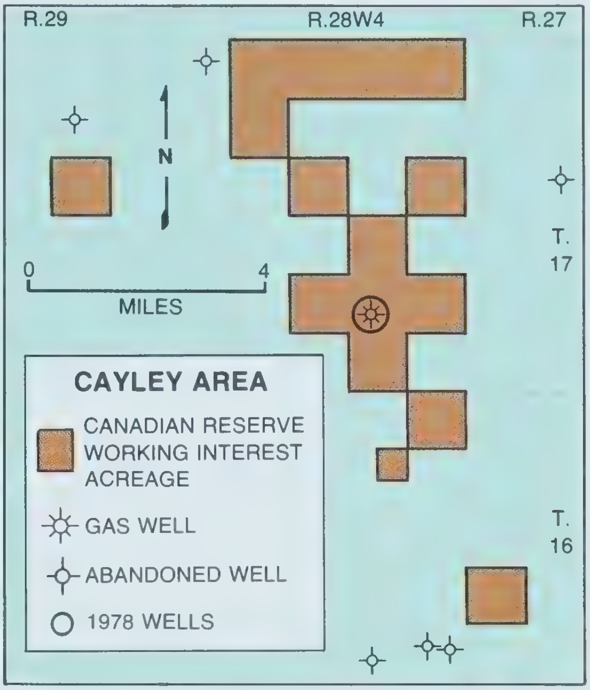
Canadian Reserve and partners purchased two licences in the Pipestone area west of Grande Prairie that are on trend with recently discovered oil, believed to be attributable to the Triassic Halfway formation. An extensive seismic program has been planned by the Company and further drilling is proposed for early 1979.



Pine Creek

Canadian Reserve and partners purchased 7,360 acres in the Pine Creek area in 1978. Subsequent drilling yielded a multi-zone natural gas well. Further drilling and land acquisitions are planned in 1979.





SOUTHERN ALBERTA

Cayley

In this area of Alberta, Canadian Reserve participated in the drilling of a 9,500 ft. Devonian test on a 11,680 acre license in which the Company has a 25% interest. This well flowed natural gas at a rate of 3.2 mmcf/d from 56 ft. of pay in the Mississippian Turner Valley formation.

HEAVY OIL AREAS — ALBERTA AND SASKATCHEWAN

In the second half of 1978, the Company resumed an aggressive exploration and development program in the heavy oil areas. Through land purchases and farmin agreements, Canadian Reserve increased its land inventory by 34,000 acres (25,000 net).

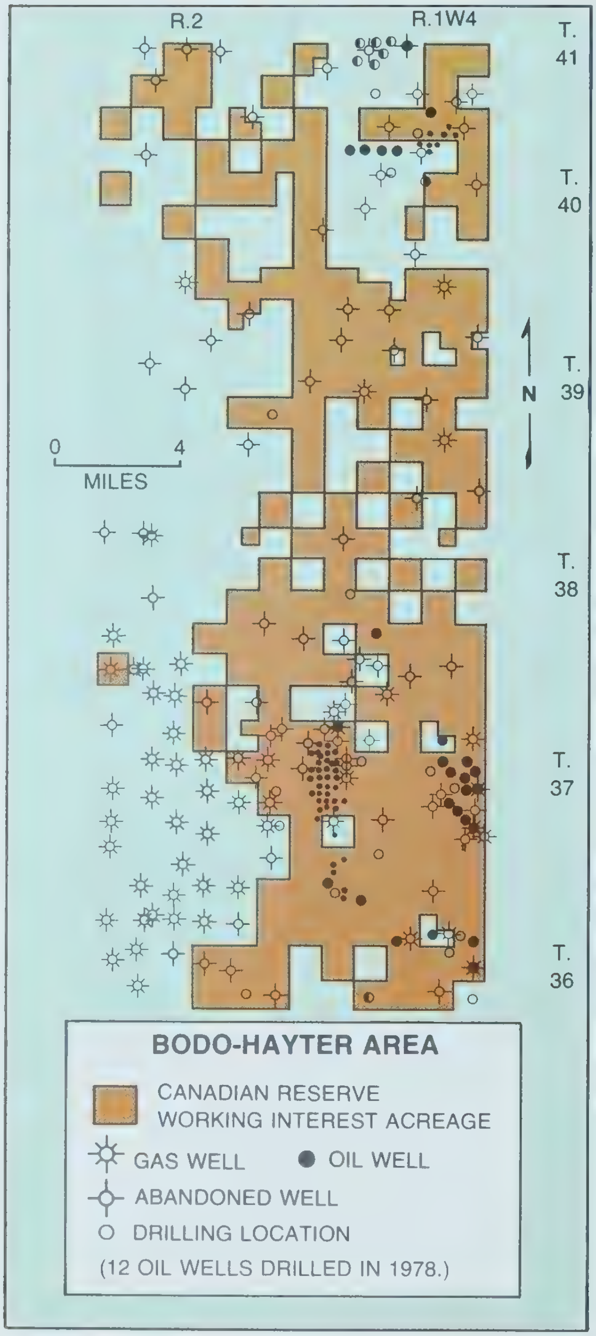
During the year, Canadian Reserve participated in a total of 102 wells (56.1 net) which resulted in 72 oil wells (44.0 net), 10 natural gas wells (3.6 net) and 20 dry holes (7.5 net).

Bodo-Hayter

During 1978, the Company participated in 12 heavy oil completions in this area of Alberta. Net pay thickness in these wells averaged 46 ft. and initial potential varies from 30 to 50 bopd. Canadian Reserve holds interests varying from $12^1/_2$% to 25% in these wells. An intense exploratory drilling program in this area was begun at the end of the year and will continue throughout 1979.

Lloydminster

In this area of Alberta, Canadian Reserve holds interests of 50% to 100% in 5,760 acres. During the year the Company drilled 6 exploratory and development wells, of which 4 were completed as Sparky oil wells, 1 was completed as a Colony-McLaren oil well and 1 well was abandoned.

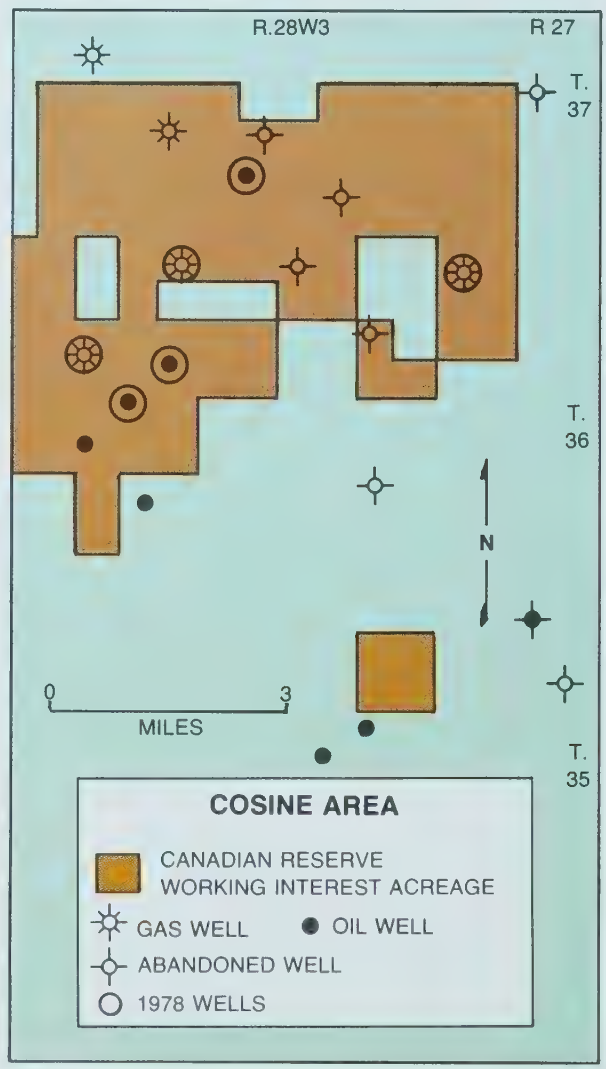


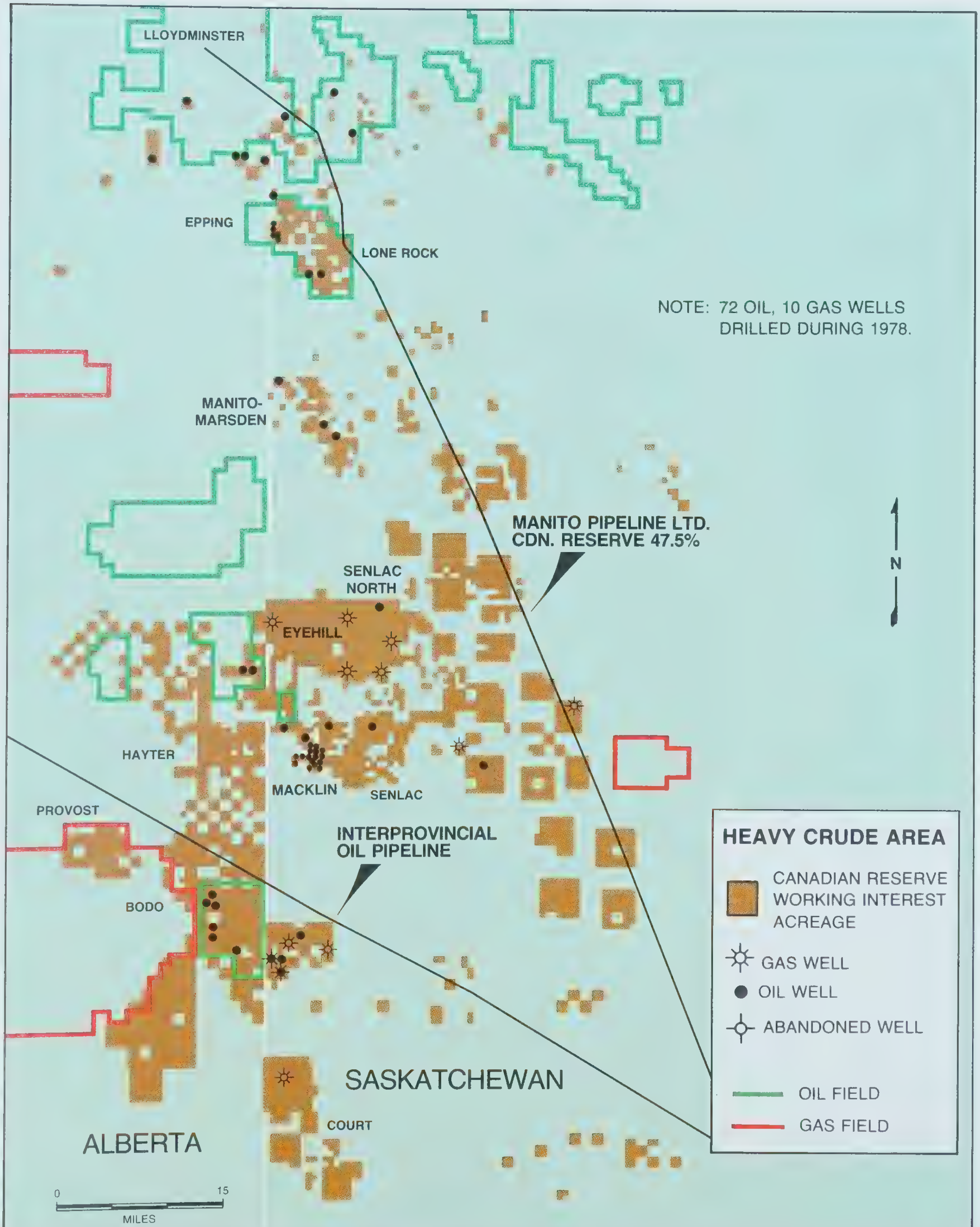
Cosine

During the year, Canadian Reserve participated in the drilling of 9 (2.5 net) exploratory wells. This program resulted in 3 (.7 net) McLaren-Waseca oil wells (2 of these had secondary natural gas sands), 1 (.3 net) potential Lloydminster oil well and 2 (.5 net) Sparky natural gas wells.

The McLaren-Waseca, which averages 46 ft. of net oil pay thickness in this area, is a continuation of the Bodo, Alberta trend and offers significant potential for application of thermal recovery techniques.

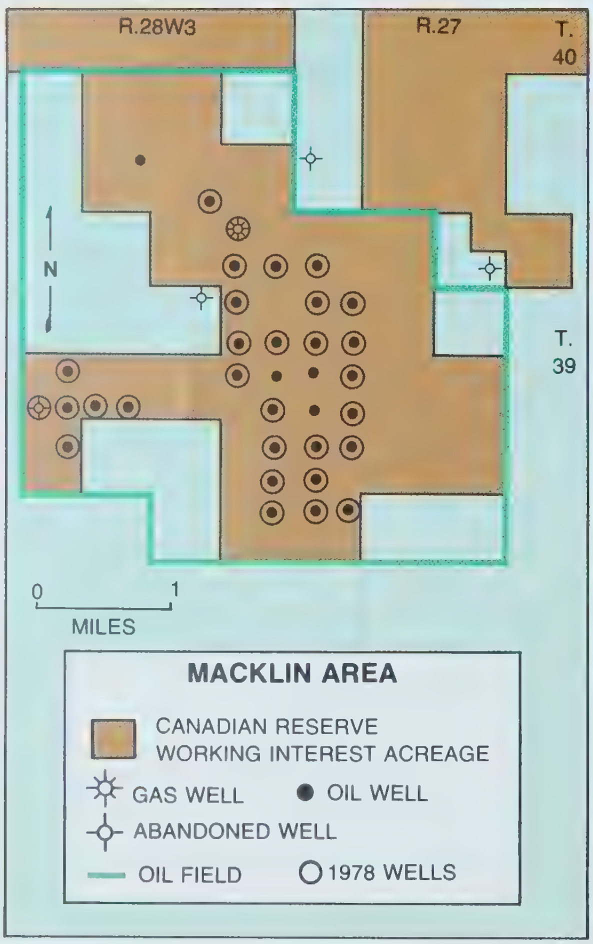
Canadian Reserve has interests which vary from 25% to 65% in 14,000 acres (4,500 net) in this area.




LLOYDMINSTER
EPPING
LONE ROCK
NOTE: 72 OIL, 10 GAS WELLS
DRILLED DURING 1978.
MANITO-
MARSDEN
MANITO PIPELINE LTD.
CDN. RESERVE 47.5%
N
SENLAC
NORTH
EYEHILL
HAYTER
MACKLIN
SENLAC
PROVOST
INTERPROVINCIAL
OIL PIPELINE
BODO
SASKATCHEWAN
COURT
ALBERTA
0
15
MILES
HEAVY CRUDE AREA
CANADIAN RESERVE
WORKING INTEREST
ACREAGE
GAS WELL
OIL WELL
ABANDONED WELL
OIL FIELD
GAS FIELD

Macklin (Eyehill)

The Company has interests varying from 50% to 100% in 4,160 acres (3,060 net) within the designated limits of this Sparky pool. During 1978, Canadian Reserve and partners drilled 30 (27.4 net) development and exploratory wells, of which 28 (25.8 net) were completed as potential Sparky producers. Average oil pay in the Sparky is 11 ft. and the average well is capable of producing 35 bopd.



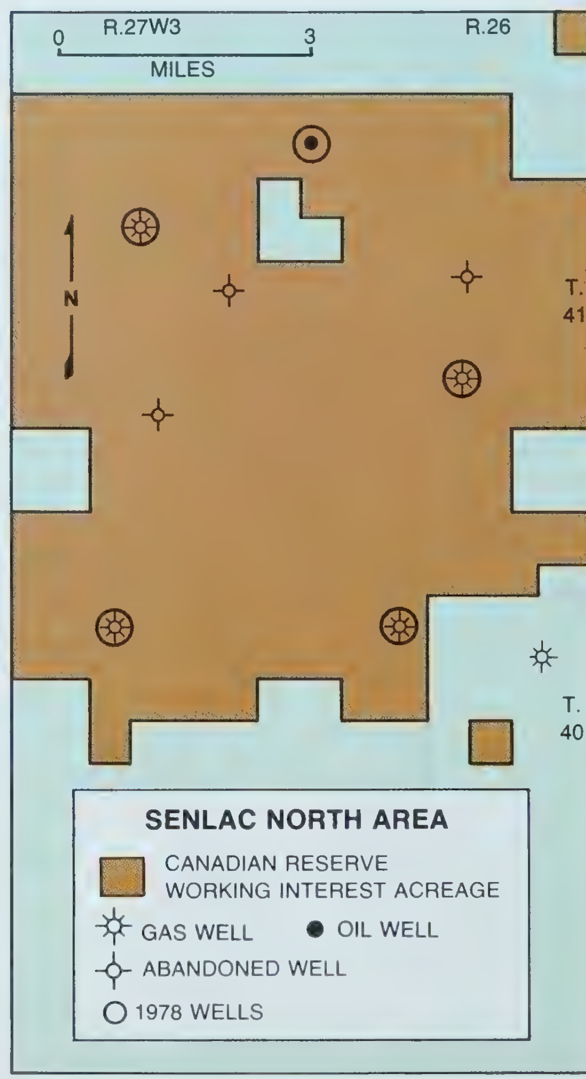
Epping

During the year, the Company participated in 8 development wells, (5.8 net), 7 of which (5.5 net) were completed as oil wells in the Sparky. Full development will take place in 1979. The Company's interest ranges from 50% to 100% in this area.

Senlac North

Canadian Reserve negotiated a farmin agreement on a 22,000 acre block in this area. Of the 5 wells drilled, 3 were completed as Viking natural gas wells with rates varying from .5 mmcf/d to 1.7 mmcf/d, 1 was completed for Colony natural gas (33 ft. net pay) and 1 was completed for McLaren-Waseca oil potential.

In 1979, Canadian Reserve plans to increase its efforts in this area and fully evaluate the potential of this significant heavy oil show.



Manito - Marsden

In 1978, Canadian Reserve participated in the drilling of 4 wells (2.2 net) in this area of Saskatchewan. Of these, 2 (0.8 net) were completed as Sparky oilwells and 1 (0.1 net) as a Colony oilwell. In 1979, the Company plans to increase its exploration and development efforts in this area in order to augment current production volumes.

LAND

At December 31, 1978, the Company held working interests in 3.6 million acres of land of which 1.3 million acres are net to the Company. The Company also holds royalty interests in 4.2 million acres of land, including lands in eastern and northern Canada. The Company increased its land holdings mainly in the Grizzly North area of British Columbia, the Pipestone area of Alberta and the heavy oil areas of Saskatchewan.

SUMMARY OF ACREAGE HOLDINGS

	Working Interest Acres		Royalty Interest Acres	
Area	Gross	Net	Gross	Net
Alberta	772,996	377,331	120,961	1,013
British Columbia	565,643	171,160	62,545	143
Saskatchewan	375,467	225,074	29,428	1,341
Manitoba	3,977	2,352	—	—
Ontario	4,918	2,958	—	—
Yukon	85,810	42,905	—	—
Northwest Territories	—	—	87,035	—
Arctic Islands	1,604,624	482,387	3,927,007	32,678
Eastcoast Offshore	187,782	37,556	—	—
	3,601,217	1,341,723	4,226,976	35,175

Production facilities in the Lloydminster Area of Saskatchewan, where the Company produces over 3,500 barrels per day of heavy oil.

OPERATIONS

DRILLING

Exploratory completions totalled 70 wells resulting in 17 oil wells, 18 natural gas wells and 35 dry holes. Canadian Reserve's interest in the successful exploratory completions resulted in 7.5 net oil wells and 4.6 net natural gas wells. The Company participated in the drilling of 201 development wells during 1978, equivalent to 53.9 net wells. Of this number, 40.3 were completed as successful oil wells, 10.5 as successful natural gas wells and 3.1 wells were abandoned. The table illustrates in more detail the drilling program for the Company in 1978. The increase in activity over 1977 was particularly evident in the Macklin, Eyehill and Manito areas of Saskatchewan.

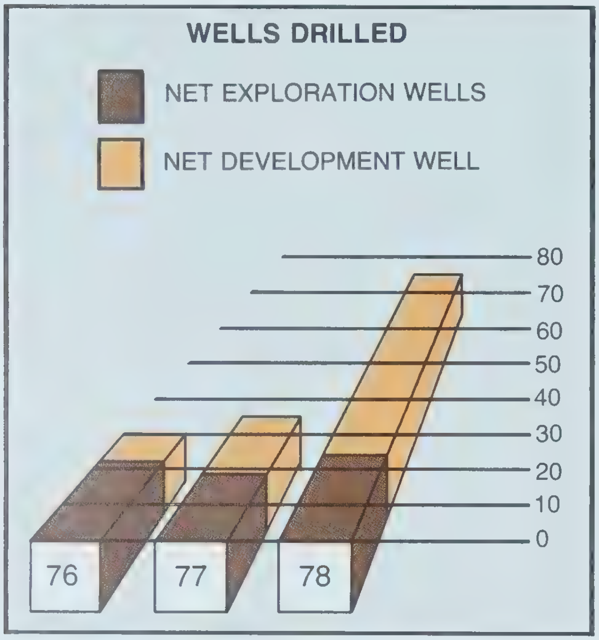
In order to ensure rig availability for drilling in the heavy oil areas of Alberta and Saskatchewan, the Company, in partnership with Canwell Drilling, undertook the construction of a drilling rig. The rig commenced operation in late August, and, since that time, has been continuously engaged by Canadian Reserve and partners. In addition, the Company has committed 2 drilling rigs to the heavy oil areas for 1979.

WELLS DRILLED

	GROSS WELLS		NET WELLS	
	1978	1977	1978	1977
DEVELOPMENT				
Oil	71	27	40.3	12.3
Gas	121	44	10.5	1.6
Dry	9	7	3.1	2.8
	201	78	53.9	16.7
EXPLORATORY				
Oil	17	8	7.5	2.4
Gas	18	17	4.6	7.1
Dry	35	23	9.7	9.8
	70	48	21.8	19.3
Total Wells	271	126	75.7	36.0

G. Czeman
Vice-President — Operations

A pumping unit in the heavy oil area of Saskatchewan, where the Company operates over 300 oil wells.



PRODUCTION AND SALES

During 1978 the gross working interest oil and natural gas liquid sales averaged 5,764 barrels per day remaining essentially unchanged from 1977. At year end, in the Macklin area of Saskatchewan, a new Sparky pool development was underway. Production from this area is expected to increase the Company's heavy oil sales during 1979.

Operation on a combination fireflood-stream stimulation pilot project at Eyehill, Saskatchewan, funded pursuant to the Canada-Saskatchewan Heavy Oil Agreement, commenced during the month of December with the drilling of the first producing wells. There will be a total of 25 wells drilled; the pilot, if successful, will increase oil recovery from 0.5% to 40% of the oil in place, or a recovery of 5,300,000 barrels for the pattern area.

The daily average gross volumes of natural gas produced by the Company in 1978 were 18.2 mmcf/d, a decrease from the 1977 level of 22.1 mmcf/d. This decrease is attributable to the reduction of sales volumes to below minimum take or pay volumes from Alberta and a combination of lack of markets and interruption of production in northeastern British Columbia.

At Dahl, in northeastern British Columbia, the Company completed construction of a compression and dehydration facility, which enabled the Company to add approximately 2 mmcf/d to its gross working interest production for approximately two and one-half months during 1978.

Gross working interest sulphur production during 1978 amounted to 124 long tons per day as compared to 117 long tons per day for 1977. The Company sold 25,607 gross long tons during 1978, a decrease of 26,048 long tons from the sale of 51,655 gross long tons during 1977.

PIPELINE TRANSPORTATION

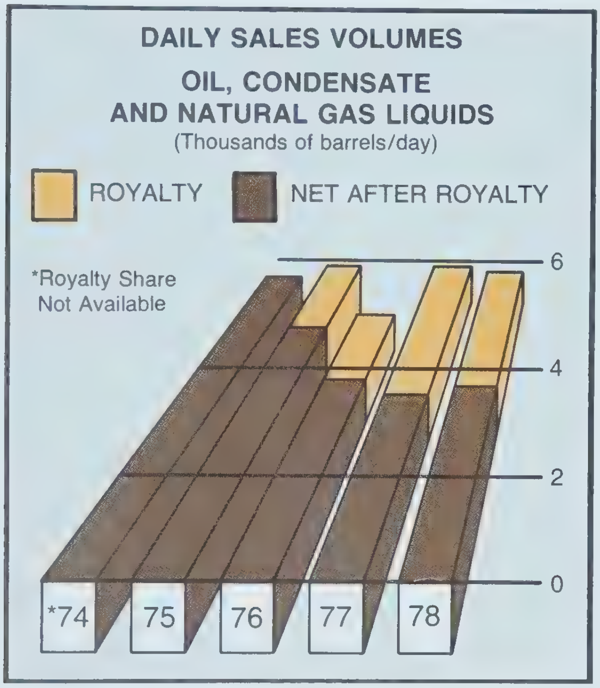
The Company owns an interest in the 115 mile Manito Pipeline Limited Pipeline System which transports an oil condensate blend in the Lloydminster area of Alberta to the oil pipeline of Interprovincial Pipeline Ltd. at Kerrobert for ultimate delivery to Canadian and United States markets.

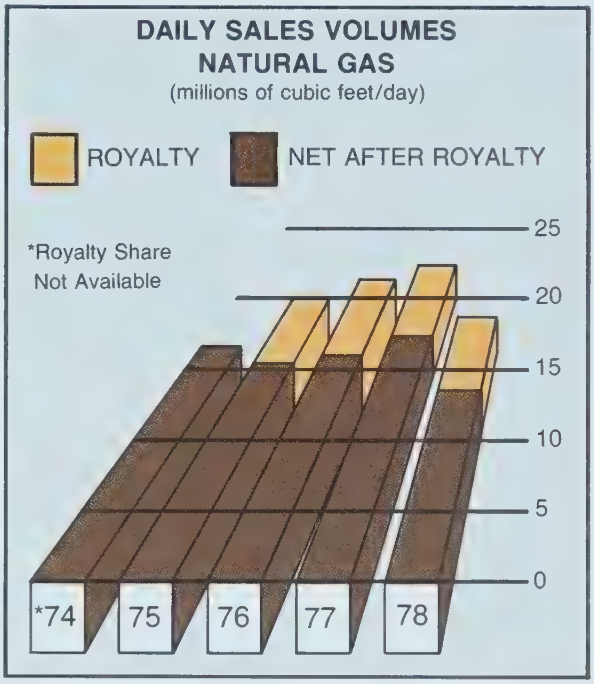
During 1978, this pipeline delivered 3,867,895 barrels of blend to the Interprovincial Oil Pipeline, an average of 10,597 barrels per day; this was an increase of 2,272 barrels per day from the 1977 average of 8,325 barrels per day. The pipeline throughput should increase in 1979, since the Company, together with other companies in the heavy oil areas, is planning an increase in its exploration and development drilling program.

Since its inception, the pipeline has experienced a steady increase in throughput volumes, and capacity restraints are now being experienced. Studies are underway to expand the existing system and possibly construct new laterals.

RESERVES

The remaining recoverable hydrocarbon reserves of Canadian Reserve at December 31, 1978, are detailed in the following table. These





Gas Plant at Dahl Field in North Eastern British Columbia, where the Company placed 8 MMCF per day on stream in 1978.

reserves were estimated by G. S. Monkhouse and Associates Ltd., an independent consulting firm.

The estimated proved and probable reserves include only those which can be classified as proved and probable in accordance with accepted American Petroleum Institute standards. The oil reserves do not include significant volumes of heavy oil which are potentially capable of recovery through thermal recovery techniques. All reserves have been calculated before royalty deductions.

	Oil	Natural Gas Liquids	Natural Gas
	(Barrels)	(Barrels)	(Millions of cubic feet)
Proved	18,942,000	2,035,100	249,236
Probable ...	17,120,300	88,500	26,280
Total	36,062,300	2,123,600	275,516

FINANCIAL REVIEW

GROSS REVENUE

Gross revenue increased $2,471,000 to $23,769,000 for the year 1978. Most of this improvement was in heavy oil, with increases in both price and volumes sold. Prices increased for other oil, natural gas and natural gas products, but sales volumes were down. The percentage increase in the average annual unit price was about the same for each category, as the following table illustrates.

	1978	1977	Increase
Oil (per bbl.)	**$10.85**	$ 9.20	18%
Natural gas (per mcf.)	**1.33**	1.14	17%
Natural gas liquids (per bbl.)	**10.90**	9.39	16%
Sulphur (per long ton)	**11.53**	10.66	8%

The share of gross revenue attributed to heavy oil increased substantially which helped to offset the marketing problems associated with natural gas. The following table illustrates the allocation of gross revenue as to heavy oil, other oil, and natural gas and its related products.

	1978		1977	
	(thousands of dollars)			
Oil — heavy	**$ 9,703**	41%	$ 7,115	33%
Oil — other	**5,728**	24%	5,298	25%
	15,431	65%	12,413	58%
Natural gas	**7,938**	33%	8,423	40%
Other	**400**	2%	462	2%
Gross Revenue	**$23,769**	100%	$21,298	100%

The effect that the natural gas marketing problem had on the geographical allocation of gross revenues is illustrated in the following table. The increase is attributed mainly to the heavy oil areas of Saskatchewan and the decrease is attributed mainly to the natural gas areas of Alberta and northeastern British Columbia.

	1978		1977	
	(thousands of dollars)			
British Columbia	**$ 2,996**	12.6%	$ 3,000	14.1%
Alberta	**10,043**	42.3%	9,691	45.5%
Saskatchewan	**10,104**	42.5%	8,092	38.0%
Manitoba	**582**	2.4%	515	2.4%
Other	**44**	.2%	—	—%
Gross Revenue	**$23,769**	100.0%	$21,298	100.0%

D. W. Talbot
Vice-President — Finance

Pursuant to the natural gas contracts which Canadian Reserve has with major purchasers, the purchaser is required to take delivery of a specified volume of natural gas annually or pay for the amount not taken. Payments due for the natural gas not taken in 1978 totalled about $540,000. The purchaser has a period varying from 5 to 10 years in which to take delivery of the natural gas paid for, but not taken, or the payment is forfeited to the Company. Accounting procedures require that this amount not be taken into income until either delivery is taken by the purchaser or the amount is forfeited.

CASH FLOW

Cash flow generated from operations, which consists of net income before deduction of all non-cash items, increased $1,469,000 or 12% to $13,713,000 for the year. These funds, amounting to $1.42 per share, were equivalent to approximately 80% of the Company's capital expenditures during the year.

DEPRECIATION AND DEPLETION

Depreciation and depletion expenses increased 6% to $3,557,000. Write-offs for oil and natural gas properties and production equipment are based on the unit-of-production method.

Under this method natural gas volumes are converted to equivalent barrels of oil based on the relative BTU content of each. The net book value of oil and natural gas properties is divided by the total equivalent barrels of proved oil reserves and multiplied by the total equivalent barrels of sales to determine the write-offs for the current year.

With the increased cost of finding and developing new reserves, the unit cost of these reserves continues to increase resulting in corresponding increases in depreciation and depletion expense.

INCOME TAXES

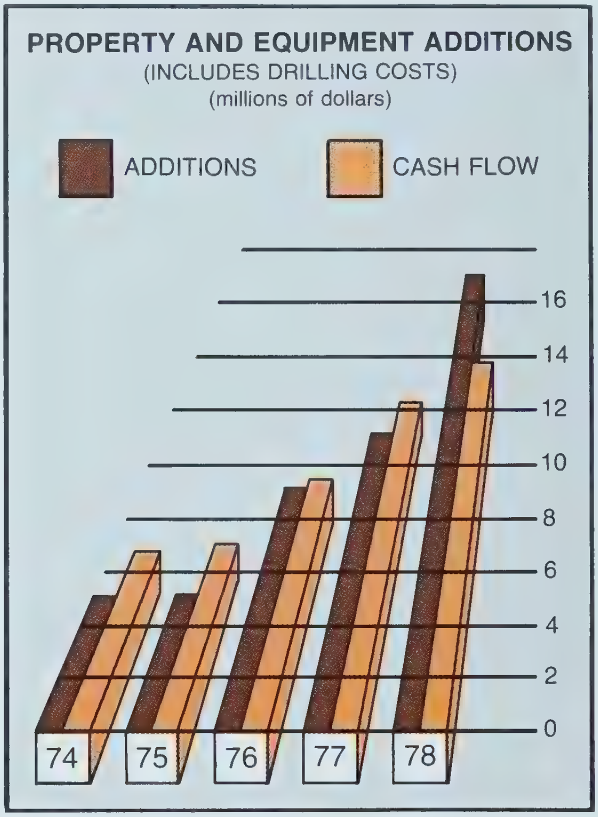
The provision for income taxes increased for the year at a rate comparable to the increase in gross revenue. This provision consists of two categories, current and deferred.

Current income taxes are the taxes payable for the year based on estimated taxable income. These taxes decreased 39% in 1978, primarily due to additional write-offs for tax purposes resulting from the heavy increase in capital expenditures during the year.

Deferred taxes consist of the additional tax that would be payable if taxes were calculated on the basis of accounting income rather than taxable income because capital expenditures are being written off at a greater rate for tax than for accounting purposes. Provision must therefore be made in the accounts to offset the taxes payable in later years when the opposite situation will occur. Deferred taxes provided for the year increased 50% to $3,318,000.

NET INCOME

Net income increased $179,000 to $6,885,000 for 1978. This resulted in $.71 per share in 1978 as compared to $.70 per share in 1977.

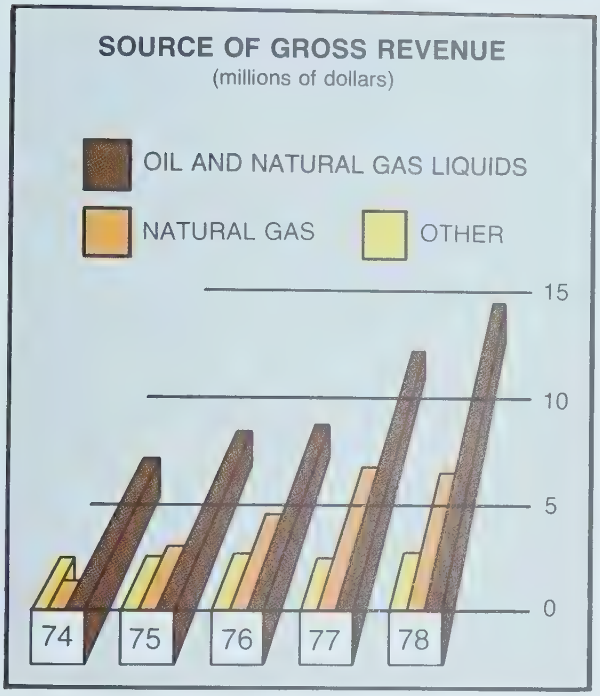


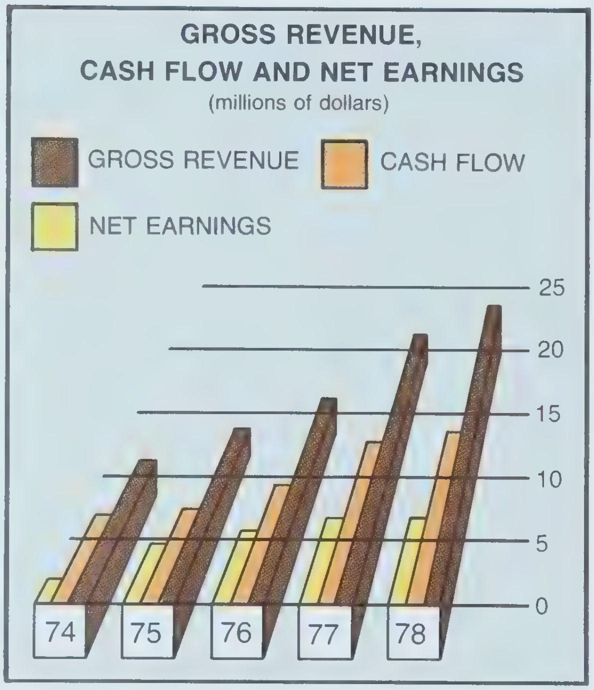
WORKING CAPITAL

Working capital at year end totalled $7,540,000 compared to $4,495,000 a year earlier. Accounts receivable and accounts payable year end balances increased substantially over the prior year. This reflects the increased amount of capital expenditures, incurred on behalf of the Company and its partners, in progress at year end. Cash balances were kept as low as practical to minimize the carrying charges on funds borrowed. The working capital ratio remained at approximately 2 to 1.

PRODUCTION LOANS

Production loans at December 31, 1978 were $7,416,300 of which $1,485,000 is considered payable during 1979 and thus has been included in the current liabilities. This increase of





$6,500,000 over the previous year end was required to finance the increased exploration and development. These loans are repayable over five years.

PROPERTY AND EQUIPMENT ADDITIONS

Property and equipment additions in 1978 amounted to $16,939,000, up 51% from 1977. The distribution of these expenditures was:

	1978		1977	
	(thousands of dollars)			
Drilling of wells	**$ 7,332**	43%	$ 5,055	45%
Leasehold acquisition	**3,063**	18%	2,430	21%
Lease and well equipment	**3,044**	18%	1,460	13%
Other facilities	**1,165**	7%	506	5%
Geological geophysical	**955**	6%	450	4%
Exploration overhead	**845**	5%	860	8%
Delay rentals	**535**	3%	438	4%
	$16,939	100%	$11,199	100%

Increased emphasis was placed on Saskatchewan heavy oil projects. The geographical distribution for 1978 (1977) was Alberta 39% (61%), Saskatchewan 35% (10%), British Columbia 25% (29%) and foreign and other 1% (0%).

1979 OUTLOOK

The outlook for 1978 in last year's report proved to be overly optimistic with regard to revenues, primarily because the natural gas marketing problems were greater than anticipated.

Preliminary estimates for 1979 indicate increases around 15% in the major income categories. This assumes continuing marketing problems for natural gas and further improvement in heavy oil sales. Capital expenditures are also expected to increase about 15% with continued emphasis on heavy oil.

BALANCE SHEET

DECEMBER 31, 1978
(with comparative amounts as at December 31, 1977)

ASSETS

	1978	1977
CURRENT		
Cash and term deposits	**$ 313,779**	$ 2,357,789
Accounts receivable	**11,564,106**	4,323,484
Inventories of crude oil and sulphur	**1,353,591**	1,406,120
Materials and supplies	**1,989,956**	1,680,289
	15,221,432	9,767,682
INVESTMENTS AND DEPOSITS	**277,971**	105,653
PROPERTY AND EQUIPMENT (Note 2)	**94,374,365**	77,764,964
Less accumulated depletion and depreciation	**28,224,222**	24,844,364
	66,150,143	52,920,600
	$81,649,546	$62,793,935

On behalf of the Board:

John R. McMillan Director

Director

See accompanying notes.

LIABILITIES AND SHAREHOLDERS' EQUITY

	1978	1977
CURRENT		
Accounts payable and accrued liabilities	**$ 6,196,856**	$ 3,525,190
Current portion of production loans (Note 3)	**1,485,000**	600,000
Income taxes payable		1,147,846
	7,681,856	5,273,036
PRODUCTION LOANS (Note 3)	**5,931,300**	290,000
DEFERRED GAS REVENUE (Note 4)	**540,635**	
DEFERRED INCOME TAXES	**16,411,000**	13,093,000
SHAREHOLDERS' EQUITY (Note 5)		
Share capital —		
Authorized:		
20,000,000 common shares of $1.00 par value each		
Issued:		
9,664,837 shares (1977 — 9,648,437)	**9,664,837**	9,648,437
Contributed surplus	**5,962,524**	5,916,568
Retained earnings	**35,457,394**	28,572,894
	51,084,755	44,137,899
	$81,649,546	$62,793,935

STATEMENT OF CHANGES IN FINANCIAL POSITION

YEAR ENDED DECEMBER 31, 1978
(with comparative amounts for 1977)

	1978	1977
Source of working capital		
Net earnings for the year	**$ 6,884,500**	$ 6,705,417
Add depletion, depreciation, deferred income taxes and other items not affecting working capital	**6,828,708**	5,538,123
Funds from operations	**13,713,208**	12,243,540
Deferred gas revenue	**540,635**	
Production loans (net of current portion — $1,485,000)	**5,931,300**	
Proceeds from sale of equipment	**198,820**	105,820
Issue of common shares for cash	**62,356**	25,016
	20,446,319	12,374,376
Application of working capital		
Additions to property and equipment	**16,939,071**	11,199,096
Acquisition of investments	**172,318**	
Repayment of production loans	**290,000**	600,000
	17,401,389	11,799,096
Increase in working capital	**3,044,930**	575,280
Working capital, beginning of year	**4,494,646**	3,919,366
Working capital, end of year	**$ 7,539,576**	$ 4,494,646

See accompanying notes.

STATEMENT OF EARNINGS AND RETAINED EARNINGS

YEAR ENDED DECEMBER 31, 1978
(with comparative amounts for 1977)

	1978	1977
Revenue	**$23,768,971**	$21,297,625
Expenses		
Operating	**6,823,736**	5,563,946
General and administrative	**1,739,939**	1,565,023
Depreciation	**1,095,639**	991,025
Depletion	**2,461,218**	2,362,994
Interest	**392,197**	212,311
	12,512,729	10,695,299
Earnings before income taxes	**11,256,242**	10,602,326
Income taxes		
Current	**1,053,742**	1,723,909
Deferred	**3,318,000**	2,173,000
	4,371,742	3,896,909
Net earnings for the year	**6,884,500**	6,705,417
Retained earnings, beginning of year	**28,572,894**	21,867,477
Retained earnings, end of year	**$35,457,394**	$28,572,894
Earnings per share (Note 7)	**$0.71**	$0.70

See accompanying notes.

NOTES TO FINANCIAL STATEMENTS

DECEMBER 31, 1978

1. Summary of significant accounting policies

Inventories

Inventories of crude oil and sulphur are carried at the lower of cost and net realizable value. Materials and supplies are carried at average cost.

Investments and deposits

Investments and deposits are carried at cost.

Property and equipment

The Company follows the full cost method of accounting wherein all costs related to the exploration for and the development of oil and gas reserves, whether productive or non-productive, are capitalized.

Depletion and depreciation

Capitalized costs of oil and gas properties including production equipment are charged against earnings on the unit of production method using estimated proven oil and gas reserves. Certain plants, pipelines and other equipment are depreciated on the straight line method at rates varying from 5% to 20%.

Income taxes

The Company practices interperiod tax allocation with respect to all significant timing differences. Investment tax credits are accounted for in the period in which they reduce the provision for income taxes.

2. Property and equipment

	1978			1977
	Investment at cost	Accumulated depletion and depreciation	Net investment	Net investment
Oil and gas properties	$68,981,780	$19,155,689	$49,826,091	$39,550,064
Plants and production equipment	19,917,900	7,240,678	12,677,222	10,282,126
Distributing pipelines	4,072,475	1,401,238	2,671,237	2,645,801
Other	1,402,210	426,617	975,593	442,609
	$94,374,365	$28,224,222	$66,150,143	$52,920,600

3. Production loans

The Company has pledged production from certain producing properties as security for its production loans which bear interest at $^1/_2$% above the current bank prime rate. Repayments of these loans are expected to amount to approximately $1,485,000 in each of the next five years.

4. Deferred gas revenue

Under the terms of contracts for the sale of the Company's natural gas, purchasers are required to pay for minimum quantities of gas each contract year. Due to lower than anticipated demand in 1978 buyers had to reduce gas purchases below minimum contract quantities and accordingly, the Company received $540,635 cash for gas not delivered. Buyers are required to take delivery of these gas deficiencies within periods ranging from five to ten years or to forfeit their payments.

5. **Stock option plan**

During the year, options to purchase 96,500 shares were granted and options to purchase 18,800 shares were cancelled. As a result of options exercised during the year, 16,400 shares were issued for $62,356 cash of which $45,956 was credited to contributed surplus. At December 31, 1978, options granted to officers and employees to purchase 334,800 shares were outstanding. These options are exercisable at various dates to July, 1988 at prices ranging from $2.03 to $11.02 per share. In addition, the Company has reserved 30,500 shares for the granting of future options to officers and employees.

6. **Statutory information**

Directors and senior officers received remuneration and benefits amounting to $450,518 during 1978 ($380,504 in 1977).

7. **Earnings per share**

Earnings per share are based on the average number of shares outstanding during the year. The exercise of the outstanding share options would have no material dilutive effect.

AUDITORS' REPORT

To the Shareholders of
Canadian Reserve Oil and Gas Ltd.

We have examined the balance sheet of Canadian Reserve Oil and Gas Ltd. as at December 31, 1978 and the statements of earnings and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1978 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Arthur Young, Clarkson, Gordon & Co.

Arthur Young, Clarkson, Gordon & Co.
Chartered Accountants

Calgary, Alberta
February 1, 1979

FIVE YEAR SUMMARY

FINANCIAL	1978	1977	1976	1975	1974
Gross Revenue	**$23,768,971**	$21,297,625	$16,111,028	$13,556,358	$10,760,945
Cash Flow	**13,713,208**	12,243,540	9,401,042	7,146,727	6,567,569
Depreciation and Depletion	**3,556,857**	3,354,019	2,706,794	2,165,701	2,498,557
Deferred Taxes	**3,318,000**	2,173,000	1,500,000	650,000	2,100,000
Net Earnings	**6,884,500**	6,705,417	5,197,614	4,319,334	1,946,343
Per Share					
Gross Revenue	**2.46**	2.21	1.67	1.41	1.12
Cash Flow	**1.42**	1.27	.98	.74	.68
Net Earnings	**.71**	.70	.54	.45	.20
Property and Equipment Additions	**16,939,071**	11,199,096	9,177,555	5,275,725	5,097,399
Working Capital	**7,539,576**	4,494,646	3,919,366	3,280,956	2,982,677
Outstanding Shares	**9,664,837**	9,648,437	9,640,437	9,635,037	9,635,037
OPERATING					
Oil and Natural Gas Liquids Sales — Barrels					
Gross Working Interest	**2,104,009**	2,125,108	1,819,981	2,190,688	*
Per Day	**5,764**	5,822	4,973	6,002	*
Net Working Interest	**1,334,394**	1,310,920	1,413,884	1,772,468	2,069,679
Per Day	**3,656**	3,591	3,863	4,856	5,670
Natural Gas Sales — mcf					
Gross Working Interest	**6,654,644**	8,069,382	7,818,312	7,266,045	*
Per Day	**18,231**	22,107	21,362	19,907	*
Net Working Interest	**4,993,490**	6,179,096	5,841,233	5,589,294	6,070,998
Per Day	**13,680**	16,929	15,960	15,313	16,633
Sulphur Sales — Long Tons					
Gross Working Interest	**25,607**	51,655	59,600	42,295	*
Per Day	**70**	142	163	116	*
Net Working Interest	**20,423**	39,873	49,494	35,850	30,460
Per Day	**56**	109	135	98	83
Wells Drilled — Gross (Net)					
Oil	**88 (48)**	35 (15)	21 (8)	23 (12)	19 (6)
Gas	**139 (15)**	61 (9)	48 (10)	7 (2)	14 (4)
Dry	**44 (13)**	30 (12)	30 (12)	26 (10)	34 (12)
Total	**271 (76)**	126 (36)	99 (30)	56 (24)	67 (22)

*Gross working interest figures not available prior to 1975.

Canadian Reserve Oil and Gas Ltd.

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